

BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
CARL E. ADAMS)

For Appellant: Rickey Ivie
w. Keith Wyatt
Attorneys at Law

For Respondent: Mark McEvilly
Counsel

O P I N I O N

This appeal is made pursuant to section 18646 of the Revenue and Taxation Code from the action of the Franchise Tax Board in denying the petition of Carl E. Adams for reassessment of jeopardy assessments of personal income tax in the amounts of \$39,139.00 and \$3,169.00 for the year 1973 and the period January 1, 1980, through February 7, 1980, respectively.

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The issues presented by this appeal are the following: (i) whether appellant received unreported income from the illegal sale of cocaine during the appeal period; and (ii) if so, whether respondent properly concluded that appellant had \$182,500 and \$1'3,000 in taxable income from such sales for the periods in issue, respectively. In order to properly consider these issues, the relevant facts concerning appellant's arrest and the **subject** jeopardy assessments **are** set forth below.

In April 1979, Detective Donald Brown of the Los Angeles Police Department ("LAPD") received information from a confidential reliable informant (hereinafter referred to as "CRI #1") to the effect that appellant was engaged in the sale of cocaine from his restaurant, Carl's Bar-B-Que, in Los Angeles. CRI #1 admitted to having purchased cocaine from appellant on numerous occasions and also stated that appellant sold approximately one ounce of the narcotic each day. Finally, CRI #1 advised Detective Brown that he had been to appellant's residence and had witnessed appellant transport cocaine to his restaurant.

Approximately six months later, Detective Brown conferred with another confidential reliable informant ("CRI #2") who corroborated the statements of CRI #1 with respect to appellant's sale of cocaine at his restaurant; CRI #2 also admitted to several cocaine purchases from appellant. Thereafter, under the supervision and surveillance of LAPD officers, CRI #2 concluded a carefully controlled purchase of cocaine from appellant; police-supplied funds were used for payment.

In late January 1980, a third confidential reliable informant ("CRI #3") advised Detective Brown that appellant was selling cocaine from his restaurant; as had the other informants, CRI #3 also admitted that he purchased the controlled substance from appellant and had been doing so for two years. On January 29, 1980, CRI #3 participated in a controlled purchase of cocaine from appellant conducted in a manner similar to that transacted by CRI #2. One of the police reports in the record of this appeal next reveals that, on January 30, 1980, Officer Robert Felix of the LAPD proceeded to appellant's restaurant in an undercover capacity and asked appellant if he could purchase one-half gram of cocaine. Officer Felix observed appellant take a box from near the cash register and remove a bindle for

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which Felix paid \$50; the bindle's contents were later tested and found to contain cocaine. This third controlled purchase was conducted with another police officer as a witness to the transaction.

In the week following the last controlled purchase, Detective Brown again spoke to CRI #3 with respect to the scope of appellant's sales of controlled substances. The informant again confirmed that he had been purchasing cocaine from appellant for an extended period of time and that the latter's cocaine sales ranged from between \$1,000 to \$1,500 daily. Based upon the investigation described above, Detective Brown requested, and obtained, a search warrant for appellant's restaurant, home, and vehicle.

On February 7, 1980, LAPD officers went to appellant's restaurant for the purpose of serving the search warrant. Upon entering the establishment, the officers observed appellant standing behind a counter area. As soon as they identified themselves, appellant turned and ran towards the rear of the building; he was observed by an officer stationed at the rear exit carrying a White Owl cigar box as he attempted to flee. Upon seeing the officer, however, appellant fled back into the restaurant where he was found by other officers in the restroom, sitting fully clothed on top of a flushing toilet with the lid down. The cigar box was located next to appellant on the floor with several receipts.

The ensuing search of appellant's vehicle and the restaurant uncovered a revolver, several items characteristic of a narcotics-selling operation, including a sifter and a sensitive weight scale, and cash in the amount of \$5,381. Upon conclusion of the search, appellant was arrested for violation of section 11352, subdivision (b), of the Health and Safety Code, i.e., sale of controlled substances by one previously convicted of a like sale or possession, as a result of the above described sale to Officer Felix. A subsequent search of appellant's residence uncovered \$17,750 in currency and a stolen revolver.

Respondent was notified of appellant's arrest on February 15, 1980. In view of the circumstances described above, it was determined that collection of appellant's personal income tax liability would be jeopardized by delay; respondent subsequently issued appellant jeopardy assessments for the year 1979 and for the period January 1, 1980, through February 7, 1980.

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In issuing **its** jeopardy assessments, respondent found it necessary to estimate appellant's income. Utilizing the then available evidence, respondent determined that appellant's total taxable income from cocaine sales in 1979 totaled \$365,000, with a resultant tax liability of \$39,139; a tax liability of \$3,169 **resulted from** estimated taxable income of \$38,000 for the taxable period of January 1, **1980, through February 7, 1980.** Pursuant to section 18817 of the Revenue and Taxation Code, respondent received from the LAPD the \$23,131 seized on **the date** of appellant's arrest.

The evidence relied upon by respondent in reconstructing appellant's income was derived from the results of the LAPD investigation and the **ensuing** arrest. Based upon that **data**, respondent computed appellant's income on the assumption that he made cumulative cocaine sales of one ounce daily resulting in daily gross receipts of **\$2,000.** That amount was then reduced to **reflect** appellant's cost of "goods" sold, estimated at **50 percent** of his selling price, to arrive at taxable income of \$1,000 daily.

On March 13, 1980, **appellant** filed a **petition** for reassessment in which he asserted that the jeopardy assessments were without any factual basis. **Respondent** thereupon **requested** that he furnish the information necessary to enable **it** to accurately **compute** his income, including income from the sale of controlled substances. In response, appellant submitted a financial statement in which he claimed that he realized gross income of \$120,000 from his restaurant in 1979 and \$15,000 through February 15, 1980; no income was **reported** from the sale of narcotics. On March 18, 1981, an oral hearing was conducted on appellant's petition. At that hearing, appellant's representative maintained that his client was not involved in the sale of Cocaine. and that the funds seized on the day of his arrest had been accumulated to pay certain bills.

Upon consideration of **appellant's petition**, respondent determined that the previously issued jeopardy assessments should be revised to reflect the most conservative estimate of **appellant's cocaine-related** income consistent with the available evidence. On March 23, 1981, respondent issued notices of action on appellant's petition reducing its computation of appellant's daily gross income from \$2,000 to \$1,000, thereby resulting in a tax liability of **\$19,064.00 for the year 1979;** a tax liability of \$918.00 was computed for the

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taxable period of January 1, 1980, through February 7, 1980.

Appellant acknowledged in the financial statement submitted to respondent as part of his petition for reassessment that he had not filed personal income tax returns since 1974. With respect to the criminal charge resulting out of his alleged sale of cocaine to Officer Felix on January 30, 1979, the record of this appeal reveals that appellant's motion for dismissal of the charge was granted because the LAPD had inadvertently lost or destroyed certain of appellant's records which he claimed would have established that he was not in Los Angeles on that date. Finally, information uncovered by respondent reveals that appellant lived in a beach area apartment with a monthly rental of \$735, was a member of an exclusive club with monthly dues of \$198, leased a Mercedes Benz automobile for approximately \$400 per month, and was making \$175 monthly payments on another imported vehicle. In addition, appellant owned rental properties and maintained known checking and savings accounts with a combined balance of almost \$15,000. Respondent's check of the quarterly sales records for Carl's Bar-B-Que showed that appellant claimed his business generated gross sales of \$123,195 in 1979 and \$67,040 for the first three quarters of 1980.

The initial question with which we are presented is whether appellant received any income from cocaine sales during the appeal period. The LAPD arrest report and Detective Brown's affidavit in support of the aforementioned search warrant, which contain references to appellant's actions and activities, the independent and corroborating statements of the three confidential reliable informants; the above described controlled purchases of cocaine from appellant, and the drug-related paraphernalia seized at the time of appellant's arrest, establish at least a prima facie case that appellant received unreported income from the illegal sale of narcotics during the appeal period.

Appellant has argued that the record of this appeal contains insufficient evidence to support a finding that appellant was engaged in a sale of cocaine. Specifically, he maintains that the only evidence of his involvement in such sales is comprised of hearsay, which is an improper basis upon which to sustain respondent's action in this matter. In support of this proposition, appellant has cited subdivision (c) of section 11513 of the Government Code and certain case authority. (See,

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e.g., Moyer v. State Board of Equalization, 140 Cal.App. 2d 651 [295 P.2d 583] (1956).) Finally, appellant apparently contends that the criminal court's dismissal of the charge against him is determinative here.

Initially, we note that this board **may** consider any relevant evidence, including hearsay evidence; provided 'that "it is the sort of evidence on which responsible persons are accustomed to rely in the conduct of serious affairs." (Cal. Admin. Code, tit. 18, reg. 5035, subd. (c).) Our consideration of such evidence is not limited by section 11513 of the Government Code. That section sets forth certain hearing **requirements** applicable to the agencies referred to in section 11501; neither respondent nor this board is referred to in section 115711. (Appeal of Sampson Dixon, Cal. St. Bd. of Equal., Nov. 17, 1982.) Appellant's citation of Moyer v. State Board of Equalization, supra, is equally misplaced. That case dealt with a period of time in which this board was subject to the provisions of section 11513 'and is therefore clearly **distinguishable** from the instant appeal. Finally, the fact that appellant was not convicted of the charge of selling cocaine to Officer Felix is not determinative as to the first issue presented by this appeal; a conviction **is not** required to support the conclusion that a *prima facie* case has been established **that** a taxpayer **received** unreported income from an illegal activity. (See, e.g., Appeal of Edwin V. Barmach, Cal. St. Bd. of Equal., July 29, 1981; Appeal of Bernie Solis, Jr. and Lucy Solis, Cal. St. Bd. of Equal., June 23, 1981.) In any event, we note that the criminal charge against appellant did not **constitute** the basis for the subject jeopardy assessment. That charge dealt with one transaction, **i.e.**, the alleged sale to Officer Felix on **January 30, 1980**. The jeopardy assessments in issue are based upon appellant's cocaine sales for the period **beginning** January 1, 1979, **through** the date of his arrest.

The second issue is whether respondent properly reconstructed the **amount of** appellant's taxable income from cocaine sales. 'Under the California Personal Income Tax **Law**, a taxpayer is required to specifically **state** the items of his gross income during the taxable year, (Rev. & Tax. Code, § 18401.) As in the federal income tax law, gross income is defined to include "all income from whatever source derived," unless otherwise provided in the law. (Rev. & Tax. Code, § 17071; Int. Rev. Code of 1954, § 61.) Gain from the illegal sale of narcotics constitutes gross income. (Farina v. McMahon, 2 Am.Fed.Tax R.2d 5918 (1958).)

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Each taxpayer is required to maintain such accounting records as will enable him to file an accurate return. (Treas. Reg. § 1.446-1(a)(4); Former Cal. Admin. Code, tit. 18, reg. 17561, subd. (a)(4), repealed July 25, 1981.) In the absence of such records, the taxing agency is authorized to compute his income by whatever method will, in its judgment, clearly reflect income. (Rev. & Tax. Code, § 17561, subd. (b).) The existence of unreported income may be demonstrated by any practical method of proof that is available. (Davis v. United States, 226 F.2d 331 (6th Cir. 1955); Appeal of John and Codelle Perez, Cal. St. Bd. of Equal., Feb. 16, 1971.) Mathematical exactness is not required. (Harold E. Harbin, 40 T.C. 373, 377 (1963).) Furthermore, a reasonable reconstruction of income is presumed correct, and the taxpayer bears the burden of proving it erroneous. (Breland v. United States, 323 F.2d 492, 496 (5th Cir. 1963); Appeal of Marcel C. Robles, Cal. St. Bd. of Equal., June 28, 1979.)

In view of the inherent difficulties in obtaining evidence in cases involving illegal activities, the courts and this board have recognized that the use of some assumptions must be allowed in cases of this sort. (See, e.g., Shades Ridge Holding Co., Inc., ¶ 64,275 P-H Memo. T.C. (1964), affd. sub nom., Fiorella v. Commissioner, 361 F.2d 326 (5th Cir. 1966); Appeal of Burr MacFarland Lyons, Cal. St. Bd. of Equal., Dec. 15, 1976.) It has also been recognized, however, that a dilemma confronts the taxpayer whose income has been reconstructed. Since he bears the burden of proving that the reconstruction is erroneous (Breland v. United States, supra), the taxpayer is put in the position of having to prove a negative, i.e., that he did not receive the income attributed to him. In order to ensure that the taxing authority's reconstruction, does not lead to injustice by forcing the taxpayer to pay tax on income he did not receive, the courts and this board have held that each assumption involved in the reconstruction must be based on fact rather than on conjecture. (Lucia v. United States, 474 F.2d 565 (5th Cir. 1973); Shapiro v. Secretary of State, 499 F.2d 527 (D.C. Cir. 1974), affd. sub nom., Commissioner v. Shapiro, 424 U.S. 614 [47 L.Ed.2d 278] (1976); Appeal of Burr MacFarland Lyons, supra.) Stated another way, there must be credible evidence in the record which, if accepted as true, would "induce a reasonable belief" that the amount of tax assessed against the taxpayer is due and owing. (United States v. Bdnaguro, 294 F.Supp. 750, 753 (E.D.N.Y. 1968), affd. sub nom., United States

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v. Dono, 428 F.2d 204 (2d Cir. 1970).) If such evidence is not forthcoming, the assessment is arbitrary and must be reversed or modified. (Appeal of Burr MacFarland Lyons, supra; Appeal of David Leon Rose, Cal. St. Bd. of Equal., March 8, 1976.)

The data relied upon by respondent in reconstructing appellant's income was derived, from the results of the LAPD investigation which culminated in appellant's February 7, 1980, arrest, certain information supplied by appellant, and data supplied by the Bureau of Narcotic Enforcement of the California Department of Justice. Specifically, respondent determined that appellant: (i) had been engaged in the "business" of selling cocaine from at least January 1, 1979, through the date of his arrest; (ii) sold an average of one-half ounce of cocaine daily at a price of \$2,080 per ounce; and (iii) had a standard cost of "goods" sold equal to 50 percent of his selling price.

The first two elements of respondent's reconstruction formula are based upon the independent and corroborating statements of the confidential reliable informants referred to above. All three informants independently stated that appellant was engaged in the sale of cocaine from his restaurant. CRI #1 informed Detective Brown that appellant sold approximately one ounce of cocaine daily; and CRI #3 advised the detective that he had been purchasing cocaine from appellant since early 1978, and that the latter's daily cocaine sales ranged from between \$1,000 to \$1,500. We believe that the statements of these reliable informants, as summarized in the affidavit of Detective Brown in support of the aforementioned search warrant, are credible, and that they support the reasonableness of respondent's reconstruction formula. Moreover, we note that there exists established authority for reliance upon data acquired from informants to reconstruct a taxpayer's income from illegal activities, provided that there do not exist "substantial doubts", as to the informant's reliability. (.Cf. Nolan v. United States, 49 Am.Fed.Tax R.2d 82-941 (1982); see also Appeal of Clarence Lewis Randle, Cal. St. Bd. of Equal., Dec. 7, 1982.) The record of this appeal provides no basis for finding that any of the informants were unreliable. To the contrary, their reliability had already been established based on information they previously had provided to law enforcement authorities. Moreover, it is relevant to note that Detective Brown was issued a search warrant based upon an affidavit which relied heavily upon the credibility of these informants.

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The final element in the reconstruction formula concerns respondent's determination that **appellant's cost** of cocaine was equal to **50 percent** of his selling price. While in previous such cases respondent has allowed taxpayers engaged in the illegal sale of controlled substances to deduct the cost of "goods" sold from gross sales to arrive at their taxable income, this deduction is now statutorily prohibited. Revenue and Taxation Code section 17297.5, effective September 14, 1982, provides, in pertinent-part, as follows:

(a) 'In computing taxable income, no deductions (including deductions **for** cost of goods sold), shall be **allowed** to any taxpayer on any of his or her gross income directly derived from illegal activities as defined, in Chapter 4 (**commencing with Section 211**) of Title 8 of, Chapter 8 (commencing with Section 314) of Title 9 of, or Chapter 2 (**commencing with Section 459**), Chapter 4 (commencing with section **484**), or Chapter '5 (commencing with Section 503) of Title 13 of, Part 1 of the Penal Code, or as defined in Chapter 6 (commencing with Section 11350) of Division 10 of the Health and Safety Code; **nor** shall any deductions be allowed to any taxpayer on, any of his or her gross income derived from any other activities which directly tend to promote or to further, or are directly connected or associated with, those illegal activities.

* * *

(c) This section shall be applied with respect to taxable years which have not been closed by a statute of limitations, res judicata, or otherwise.

The sale of controlled substances, including, cocaine, constitutes an illegal activity as defined by chapter 6 of division 10 of the Health and Safety Code. (Health & Saf. Code, §§ 11350, et seq.) Accordingly, no deduction for appellant's cost of "goods" sold is allowable.

Again, we emphasize that when a taxpayer fails to comply with the law in supplying the information required to **accurately compute his income**, and respondent finds it **necessary** to reconstruct the taxpayer's income, some reasonable basis must be used. Respondent must resort to various sources of information to

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determine such income and the resulting tax liability. In such circumstances, a reasonable reconstruction of income will be presumed correct, and the taxpayer has the burden of proving it erroneous. (Breland v. United States, supra; Appeal of Marcel C. Robles, supra.,) Mere assertions by the taxpayer are not enough to overcome that presumption. (Pinder v. United States, 330 F.2d 119 (5th Cir. 1964).) Given appellant's failure to provide any evidence challenging respondent's reconstruction of his income from cocaine sales, we must conclude that respondent reasonably reconstructed the amount of such income.

Based upon the above, we conclude that-appellant received a total of \$365,000 in unreported taxable income from the illegal sale of cocaine in 1979 and **\$38,000 from** such sales during the period January 1, 1980, through February 7, 1980. These amounts are substantially in excess of those computed by respondent and are sufficient to sustain the subject jeopardy assessments in their entirety.

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O R D E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and **good** cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 18595 of the Revenue and Taxation Code, that the action of the Franchise Tax Board in denying the petition of Carl E. Adams for reassessment of jeopardy assessments of personal income tax in the amounts of **\$39,139.00** and **\$3,169.00** for the year 1979 and the period January 1, 1980, through February 17, 1980, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this 1st day of March , 1983, by the State Board of Equalization, with Board **Members** Mr. Dronenburg, Mr. **Collis**, Mr. Nevins and Mr. Harvey present.

_____, Chairman
Ernest J. Dronenburg, Jr., Member
Conway H. Collis, Member
Richard Nevins, Member
Walter Harvey*, Member

*For Kenneth Cory, per Government Code Section 7.9